| | Office of Chief Counsel Internal Revenue Service |
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| | memorandum CC: TL-N-8315-98 |
| date: | JAN 29 1999 |
| to: | Examination Division, ATTN: |
| from: | Associate District Counsel, |
| ubject: | |

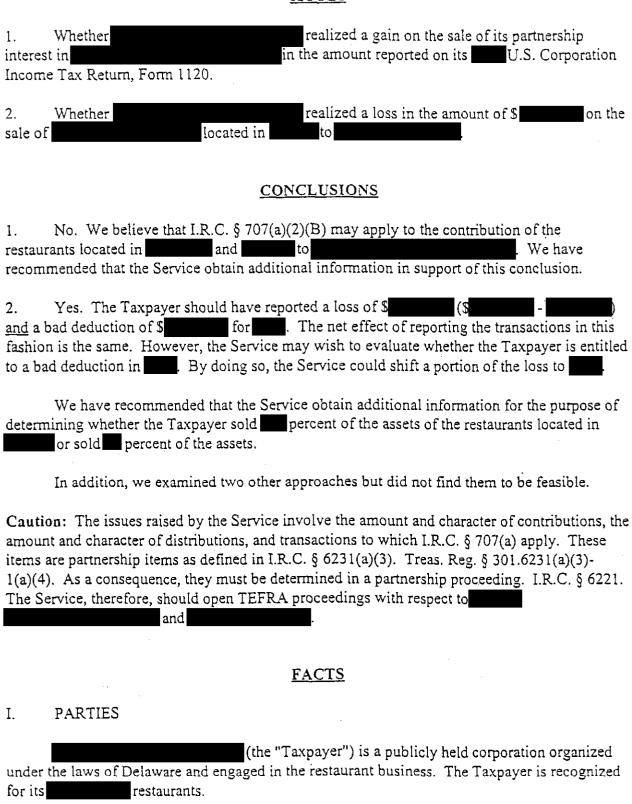
This memorandum responds to your request for advice concerning the treatment of a transaction in which contributed assets to a partnership and immediately sold the partnership interest received in exchange for the contribution.

DISCLOSURE LIMITATIONS

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUES



changed its name

changed its name to

began as a on reincorporated in Delaware in

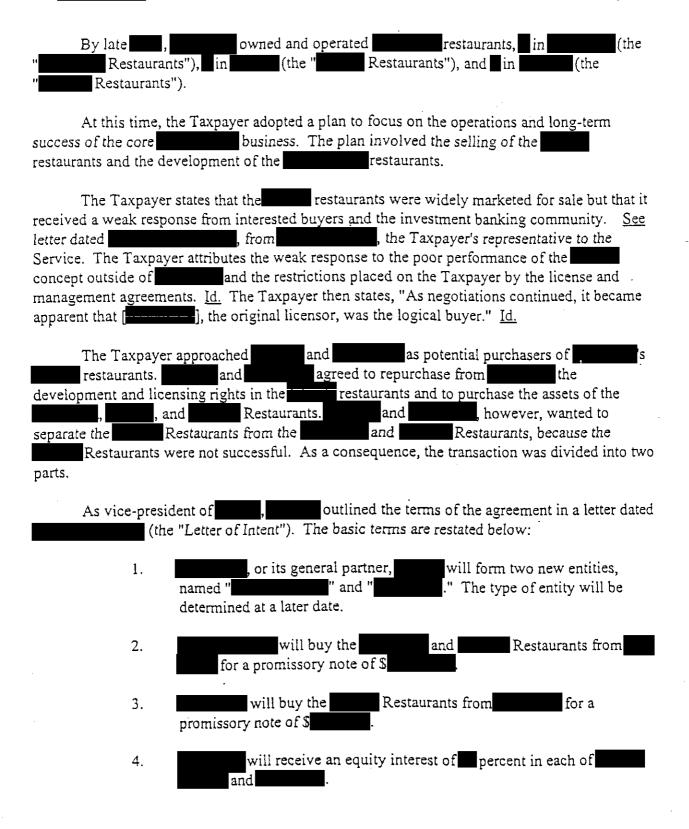
| and incorporated in or about restaurants. | ') is a Delaware corporation where for the purpose of acquiring cert. | |
|--|--|---|
| (" ") and | ' ' ' ' ' ' ' ' ' ' ' ' ' ' ' ' ' ' ' | owned equally by ators of the concept. |
| | (" percent general partnership interestogether own a percent limited l | est in while |
| formed on, for t | ("Leave the purpose of owning and operating | ware limited partnership restaurants located in |
| formed on, for is owned as follows: | (" ") is a De the purpose of holding an interest in | laware limited partnership |
| <u>Partner</u> | <u>Interest</u> | Percentage |
| | General Partner | % |
| | Limited Partner | % |
| is a Del | laware corporation owned equally by | y and . |
| , for the purpose of ow was owned as follow | ") was a Delaware limited vning and operating the resta | · |
| | | |
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| | | |
| back to in | ne to on | and then changed its name |

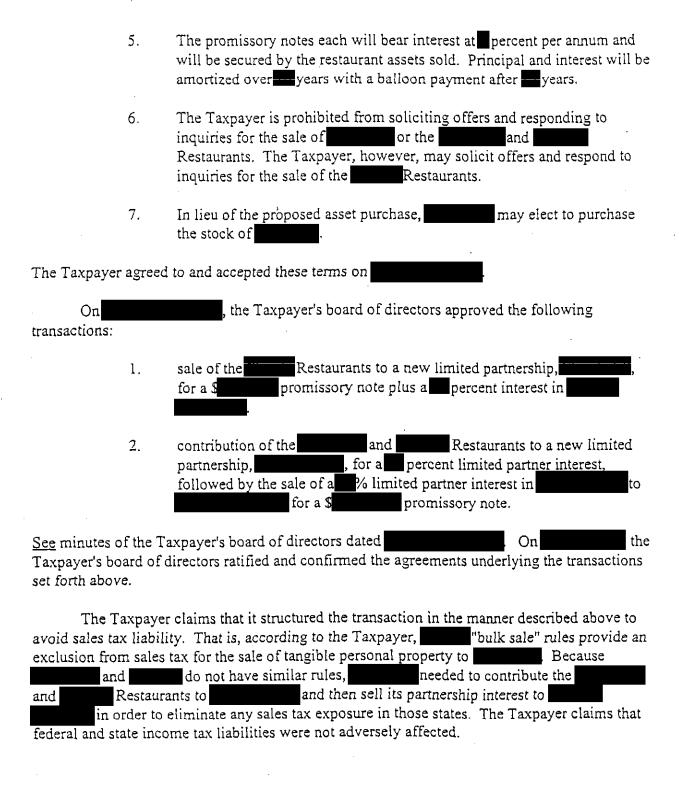
corporation incorporated as , the same day as

| | Partner | Interest | Percentage |
|--------------|--|--|--|
| • | | General Partner Class B Limited Partner | % % |
| | | Class A Limited Partner | % |
| | dissolved on | | |
| follow | • • | ") is a Delaware limited ing an interest in . | partnership formed on is owned as |
| | Partner | Interest | Percentage |
| | | General Partner | % |
| | | Limited Partner | |
| As sta | ted above, | is a Delaware corporation own | ed equally by |
| | | | |
| II. | BACKGROUND | | |
| | The Taxpayer and its subsidiarie | es (including file a co | onsolidated return. |
| differe | In the late state state its state in a chain of state restaurant | restaurants. Specifically, th | |
| in operat | and from | evelopment rights and a license. At the same time, the Trate existing restaurants | axpayer entered an |
| throug | cense Agreement ("Restated Deve to obtain the exclusive right and shout the world for a term of year y fee equal to percent of its gros | license to establish and operate ars. also was require | paid \$ restaurants ed to pay a quarterly nts and to develop new |

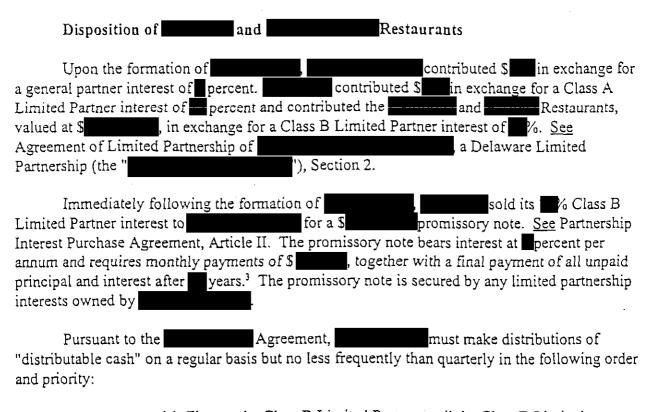
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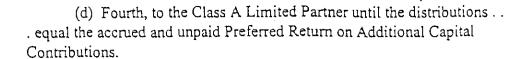


III. TRANSACTIONS AT ISSUE



- (a) First, to the Class B Limited Partner until the Class B Limited Partner has received distributions . . . equal to the accrued and unpaid Preferred Return.
- (b) Second, to the Class B Limited Partner until the distributions... equal the Class B Limited Partner's unpaid Capital Distributions then due.
- (c) Third, if the balance in the Reserve Fund is less than the amount (the "Minimum Reserve Balance") that is the lower of (i) (\$\frac{1}{2}\text{Constant}\

³ The file contains only an unexecuted copy of the promissory note. Therefore, the terms of the promissory note may be different than those stated.



- (e) Fifth, to the Class A Limited Partner until the Adjusted Additional Capital Contributions of the Class A Limited Partner are reduced to zero.
- (f) In all other cases, Distributable Cash shall be distributed percent (2%) to the General Partner, (2%) to the Class A Limited Partner, and percent (2%) to the Class B Limited Partner.

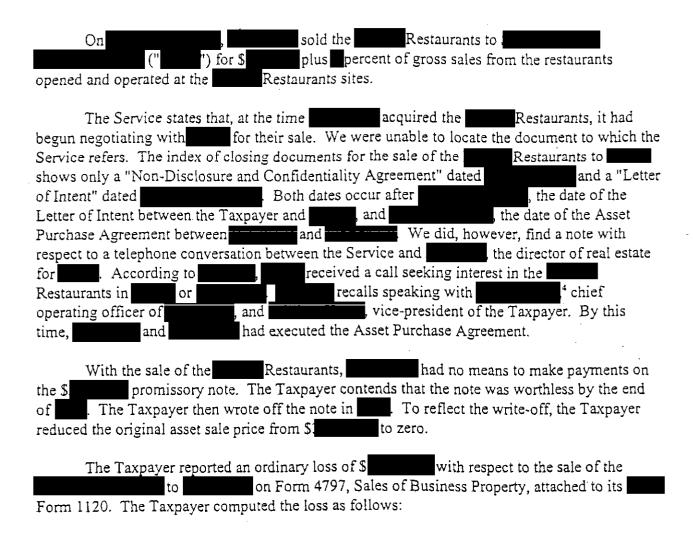
To the extent that the total distributions provided for in Sections 4.1(a) or 4.1(b) during any Fiscal Year exceed the amount of Distributable Cash, the Partnership shall withdraw cash in the amount of such excess from the Reserve Fund and shall distribute such cash in accordance with Sections 4.1(a) and 4.1(b)...

See Agreement, Section 4.

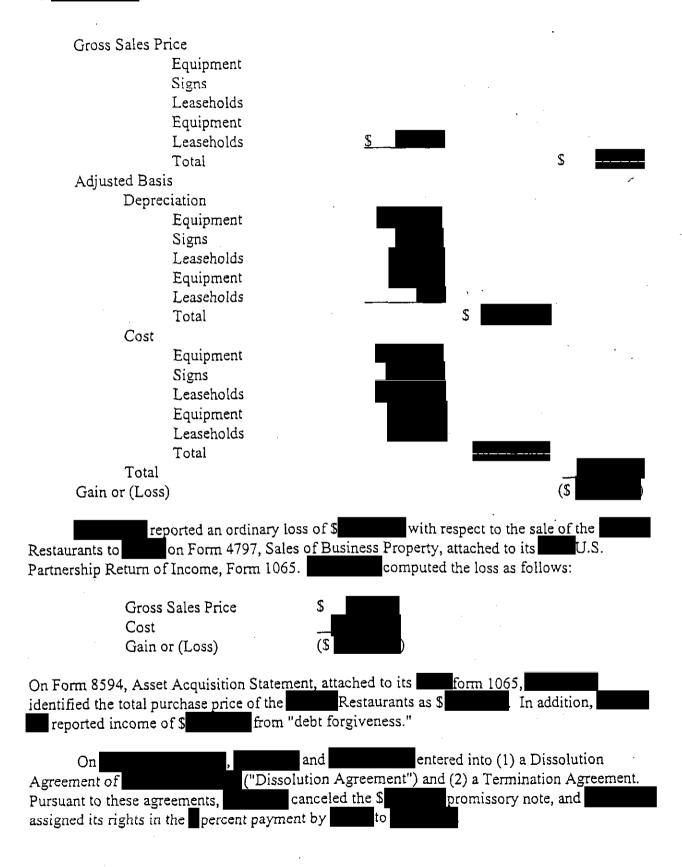
The Agreement provides the following definitions for the capitalized terms above:

- 1. "Distributable Cash" means the gross cash proceeds from Partnership operations less the portion thereof used to pay or establish reasonable reserves for all Partnership expenses (not including amounts deposited in the Reserve Fund), debt payments, capital improvements, replacements, and contingencies.
- "Preferred Return" means a sum equal to percent per annum "(or percent () per annum after the occurrence and during the continuation of an Event of Default as defined in the Loan Agreement . . . between [and []) . . . of the average daily balance of the aggregate "Adjusted Capital Contributions" of the Class B Limited Partner . . . "Adjusted Capital Contributions" means the \$ capital contribution made in exchange for the Class B Limited Partner Interest . . . reduced by the amount of cash distributed to the Class B Limited Partner pursuant to sections 4.1(b) and 13.2(c) of the Agreement.

| | 3. | "Capital Distributions" means a series of distributions to be made to the Class B Limited Partner in the amounts, and on or after the dates, set forth on Schedule 2 of the Agreement. |
|----------------------------|--------------------------|---|
| | 4. | "Reserve Fund" means funds "held in the Collateral Account that will be established in connection with that certain Reserve Fund Pledge Agreement, by and among the Partnership, the General Partner, the Class A Limited Partner, and the Bank named therein." |
| | 5. | "Promissory Note" means "that certain secured promissory note made in favor of the Class A Limited Partner by the General Partner in the principal amount" of \$ |
| <u>See</u> | A | greement, Exhibit A, Glossary. |
| | | apparently has made each payment required under the promissory note. |
| its interest | in | on Schedule D, Capital Gains and Loss, attached to its U.S. Tax Return, Form 1120. The Taxpayer computed the gain as follows: |
| | Gros Cost Gain | |
| The cost i | dentified | equals percent of the cost for the and Restaurants. |
| n: | sposition | of Restaurants |
| Or entered Restauran | n d into a A ts to | , the same day as the formation of section, and sect Purchase Agreement, pursuant to which sold the for a promissory note of section. The note bore interest at a rate of and provided for a schedule of payments. |
| under the | ayer states | apparently did not make any payments on the \$ promissory note. It that it became clear that would not be able to meet its obligations that the note was worthless. As a consequence, the Taxpayer states that a to find a buyer for the Restaurants. See letter dated |



apparently worked for the Taxpayer or prior to the Taxpayer of the employ of the Taxpayer upon the closing of the transactions to continue with the state of the operating officer.



DISCUSSION

I. DISPOSITION OF AND AND RESTAURANTS

As a general rule, neither a partnership nor any of its partners recognizes gain or loss on the contribution of property to the partnership in exchange for an interest in the partnership. I.R.C.§ 721(a). The general rule, however, does not apply to a transaction between a partnership and a partner not acting in his capacity as a partner. Treas. Reg. § 1.721-1(a).

Rather than contributing property to a partnership, a partner may sell property to the partnership or may retain the ownership of property and allow the partnership to use it. In all cases, the substance of the transaction will govern, rather than its form. . . . Thus, if the transfer of property by the partner to the partnership results in the receipt by the partner of money or other consideration, including a promissory obligation fixed in amount and time for payment, the transaction will be treated as a sale or exchange under section 707 rather than as a contribution under section 721.

Id.

A transaction shall be considered as occurring between the partnership and one who is not a partner, if a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership. I.R.C. § 707(a)(1). A partner is not acting in his capacity as a member of a partnership in the following situation:

- 1. the partner directly or indirectly transfers money or other property to the partnership;
- 2. the partner receives a related direct or indirect transfer of money or other property from the partnership; and
- 3. the transfers, when viewed together, are properly characterized as a sale or exchange of property.

I.R.C. § 707(a)(2)(B). The transaction described above constitutes a sale of property, in whole or in part, by the partner to the partnership only if based on all of the facts and circumstances,

- 1. the transfer of money or other consideration would not have been made but for the transfer of property; and
- 2. in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.

Treas. Reg. § 1.707-3(b)(1).

Caution

Before going further, we must advise you that generally, items relating to the following transactions, "to the extent that a determination of such items can be made from determinations that the partnership is required to make with respect to an amount, the character of an amount, or the percentage interest of a partner in the partnership, for purposes of the partnership books and records or for purposes of furnishing information to a partner" are partnership items as defined in I.R.C. § 6231(a)(3): (1) contributions to a partnership, (2) distributions from a partnership, and (3) transactions to which I.R.C. § 707(a) applies. Treas. Reg. § 301.6231(a)(3)-1(a)(4). For purposes if its books and records, the partnership needs to determine:

- 1. the amount transferred from the partnership to a partner or from a partner to the partnership in any transaction to which I.R.C. § 707(a) applies;
- 2. the character of such an amount; and
- 3. the percentage of the capital interests and profits interests in the partnership owned by each partner.

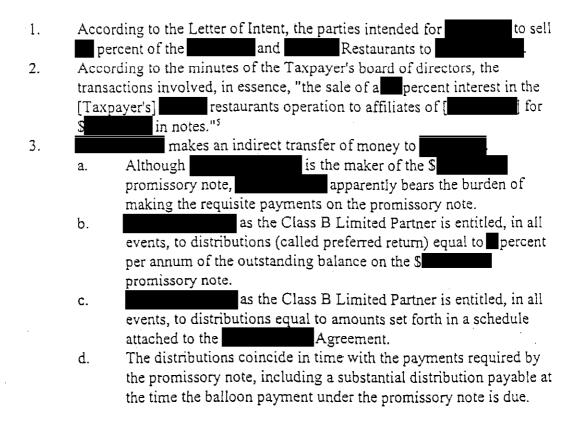
Treas. Reg. § 301.6231(a)(3)-1(c)(4).

To the extent that a determination of an item relating to a transaction to which section 707(a) applies can be made from these and similar determinations that the partnership is required to make, therefore, that item is a partnership item. To the extent that that determination requires other information, however, that items is not a partnership item. An example of such other information is the cost to the partner of goods sold to the partnership.

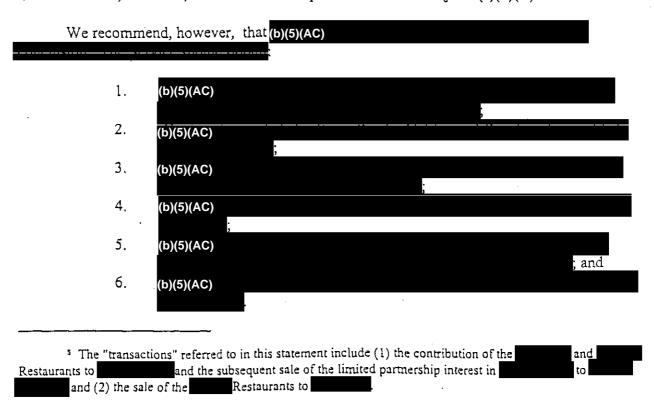
Id. As such, the items identified above must be determined at the partnership level. I.R.C. § 6221. And the Service should open a TEFRA partnership proceeding with respect to

Application to Facts

| In this case, | contributed the | and Res | taurants to |
|--------------------------|------------------------------|------------------------|-------------|
| in exchange for a | 6 Class B Limited Partner i | nterest. Immediately | thereafter, |
| sold its Class B Limited | | for \$ | |
| The transaction, h | nowever, resembles, at least | in part, a sale of the | and |
| Restaurants to | for the following reaso | ns: | |



The transaction, therefore, meets all of the requirements of I.R.C. § 707(a)(2)(B).



These items, if consistent with the terms of the Agreement and the promissory note, should establish that made indirect transfers of money to

The question then becomes whether the transaction should be treated solely as a sale or as a part sale, part contribution. If the transaction is treated solely as a sale, the transaction would result in gain calculated as follows:

This gain is the same as that reported by the Taxpayer on its Form 1120.

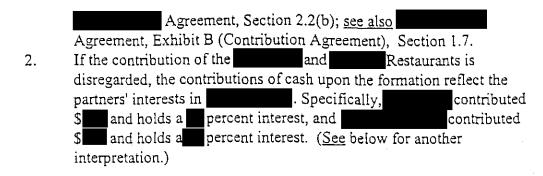
This gain is the gain proposed by the Service in its examination.

We find several facts that support treating the transaction solely as a sale, as well as several facts that support treating the transaction as a part-sale, part-contribution. We believe the following facts support treating the transaction solely as a sale:

1. In the Agreement, the parties set the gross value of <u>all</u> of the assets of the Agreement and Restaurants at \$ ______ See

The liabilities relieved would equal percent of liabilities associated with the second and Restaurants.

⁷ In its analysis, the Service reduced the Taxpayer's adjusted basis of \$ by \$ the cost of certain intangibles, before multiplying by percent. Intangibles are not property used in a trade or business as defined by I.R.C. § 1231(b). The gain resulting from this analysis is \$ for simplicity, we did not subtract \$ from the Taxpayer's adjusted basis.



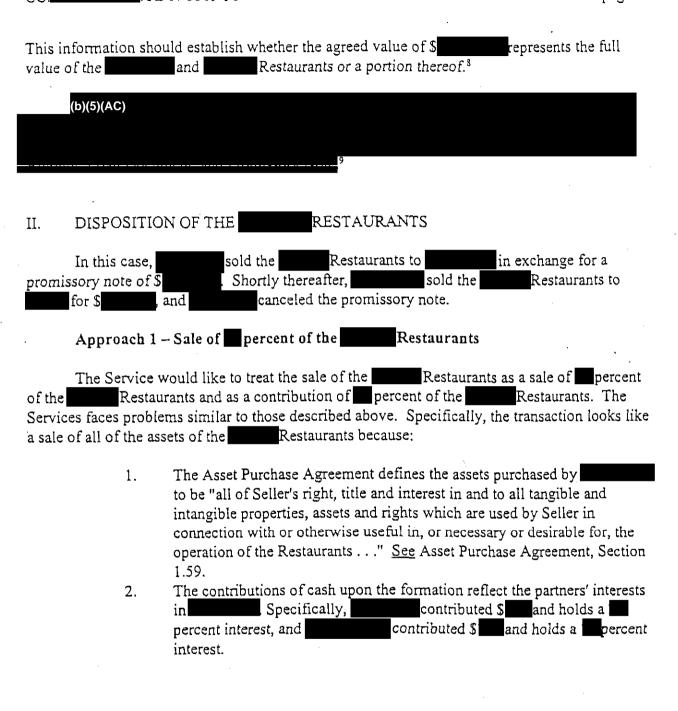
We believe that the following facts support treating the transaction as a part sale, part contribution.

- According to the Letter of Intent dated to the parties intended for to sell percent of the and and Restaurants to the minutes of the Taxpayer's board of directors, the
 - transactions involved, in essence, "the sale of a percent interest in the [Taxpayer's] restaurants operation to affiliates of [for \$ in notes."
- The contributions of cash are disproportionate and do not correspond with the interests received in exchange for such contributions. Specifically, contributed \$ in exchange for a percent interest, while contributed \$ in exchange for a 1 percent interest.

 To give economic substance to the contributions, it is logical to assume that contributed \$ plus a portion of the assets of the and Restaurants for the percent interest.

To resolve this issue, we recommend that the Service obtain the following information:

| 1. | (b)(5)(AC) | |
|----|------------|--|
| | | |
| 2. | (b)(5)(AC) | |
| 3. | (b)(5)(AC) | |
| | | |



^{*} See Jacobson v. Commissioner, 96 T.C. 577 (1991). This Court concludes that the transaction involved a part contribution of the property to the partnership and a part sale of the property to the other partner. Although I.R.C. § 707(a)(2)(B) did not apply to the facts of <u>Jacobson</u>, the analysis regarding how the Court reached its conclusion is helpful to this case.

^{9 (}b)(5)(AC)

| The only support for treating the transaction as a sale of percent of the Restaurants is the intent of the parties as evidenced by the Letter of Intent and the minutes of the Taxpayer's board of directors dated | | | | |
|--|--|--|--|--|
| We recommend that the Service obtain the information identified above with respect to the disposition of the and and Restaurants. | | | | |
| (b)(5)(AC) | | | | |
| | | | | |
| Approach 2 – Deduction for Bad Debt | | | | |
| The Service also could attack the Taxpayer's method of reporting of the sale of the Restaurants. The Taxpayer did not report the sales price as \$ Instead, it reduced the original sales price by \$ to reflect the cancellation of the promissory note. | | | | |
| We do not believe that this is a proper reporting of the transactions. The Taxpayer should have reported the sales price as \$\frac{1}{2}\text{and reported}\$ and reported the cancellation of the promissory note as a bad debt. Admittedly, reporting the transaction in this fashion leads to the same result as the reporting by the Taxpayer on its \$\frac{1}{2}\text{Form 1120}\$. However, it leads to the same result only if the Service accepts that the promissory note was worthless as of | | | | |
| (b)(5)(AC) | | | | |
| Approach 3 - Sale of the Restaurants by Directly to | | | | |
| The Service has suggested another approach, using the substance-over-form doctrine and/or the step-transaction doctrine to treat as having sold the Restaurants directly to for Service. The Service argues that had begun negotiations with Restaurants prior to the time at which it sold the Restaurants to . | | | | |
| (b)(5)(AC) | | | | |
| | | | | |
| | | | | |
| | | | | |
| | | | | |

| (b)(5)(AC) | | |
|--|--|--|
| | Sale to(b)(5)(AC) | Sale to(b)(5)(AC) |
| Sales Basis Loss | _ | \$ (b)(5)(AC) (\$ |
| (b)(5)(AC) | | |
| (b)(5)(AC) | | |
| Approach 4 | – Contribution of the | Restaurants to |
| The Service Restaurants to loss to , the year | as a contribution to ca | pital. By doing so, the Service could shift the and could recharacterize the loss as capital. |
| note. First, | | vice would attack the validity of the promissory any of payments on the note. Second, payment e so operations. |
| fiftee lesse [1]'s "Cas' the C the ir amou | onth day of each month in more rof (a) \$ (the "Fixe Net Income received during the Payment") In the | ue and payable in arrears on the onthly installments equal to the ed Payment") and (b) [|
| See Promissory Not months after the sale | e, Section 2(b). Finally, | canceled the promissory note only or |
| Having said | that, however, (b)(5)(AC) | |

For a cases in which the court found a contribution of property instead of a sale of property, see Oliver v. Commissioner, 13 TCM 67 (1954) and Castle Heights, Inc. v. United States, 242 F.Supp. 350, 65-1 USTC ¶ 9483 (ED Tenn. 1965).

| (b)(5)(AC) | | |
|------------|------|------|
| | | ···· |
| | | |
| | | |
| | | |
| (b)(5)(AC) | | |

If you have any questions, please call me at

Assistant District Counsel

By:

Attorney

cc: ARC(TL)